Internal Revenue Service

memorandum

CC:TL-N-4883-90
Br4:GBFleming

date: JUN 15 1990

to: District Counsel, Dallas SW:DAL
Attention: Gary D. Kallevang

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted] v. Commissioner,
T.C. Docket No. [redacted]

This responds to your memorandum dated March 13, 1990, requesting Tax Litigation Advice concerning the above-captioned case. Your memorandum indicated that this case is one of several pending cases involving the issue which is the subject of your request.

ISSUE

Whether the "project beginning date" under I.R.C. § 4993(d)(2) 1/ for a qualified tertiary recovery project under the windfall profit tax (WPT) is the date on which a preflush begins in a case where the preflush extends approximately five years, after which time the project is terminated and decertified without ever commencing use of the primary injectant.

CONCLUSION

We have concluded that the failure to commence use of a primary injectant requires treatment of the subsequent decertification as retroactive -- i.e., effectively invalidates the original certification of the project. Accordingly, we have concluded that respondent's position that there was no qualified tertiary project (and thus no "project beginning date") in this case is technically correct. We are concerned, however, that there are significant hazards in litigating the issue in this particular case, and we strongly recommend that efforts be made to negotiate a settlement.

1/ Code references are to the Internal Revenue Code of 1954 in effect during [redacted] and [redacted] the years at issue in this case.

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FACTS

The petitioner is a royalty owner in the [redacted] (the "Unit"), having acquired her royalty interest by inheritance. The Unit covers [redacted] acres in the [redacted], located in [redacted], California. Primary production began in [redacted] on the leases that make up the Unit, which was formed on [redacted], in order to conduct a secondary recovery waterflood operation.

The waterflood injection was begun in [redacted], using [redacted] injection wells at the rate of approximately [redacted] barrels of water per day (BWPD). As of [redacted], the water injection rate had decreased to [redacted] BWPD using [redacted] active injection wells.

On [redacted], the Unit operator, submitted a request for certification of an enhanced oil recovery project on the Unit as a "qualified tertiary recovery project" under I.R.C. § 4993. The request was submitted to the California Department of Conservation, Division of Oil and Gas (DOG), which was designated as the state agency for certification of qualified tertiary recovery projects in California pursuant to I.R.C. § 4993(d)(5)(A)(i).

The request for certification proposed a caustic (alkaline) flood project to commence with injection of a softened brine preflush to run from [redacted] until August [redacted], when use of the alkaline injectant would begin. The project plan called for use of the alkaline injectant until [redacted].

The DOG initially certified the project on [redacted]. Subsequently, on [redacted], [redacted] requested a revised certification based on using softened fresh water rather than softened brine for the preflush. The DOG issued a revised certification on [redacted].

In [redacted] the existing secondary waterflood program on the [redacted] was converted from a peripheral arrangement to an inverted nine-spot pattern in preparation for the caustic (alkaline) flood. This conversion entailed the drilling of [redacted] wells, the redrilling of [redacted] well, and the stimulation of [redacted] wells.

Superior began injecting softened water on [redacted]. The softened water preflush continued until [redacted], when it was discontinued by [redacted], which had acquired [redacted] in [redacted] and succeeded to [redacted]'s role as operator. Termination of the project occurred before using any primary injectant. The project was apparently terminated

because of the worldwide decline in the price of crude oil and the projected need to inject more alkaline material than originally planned.

On [redacted], [redacted] notified the DOG that the alkaline flood was terminated on [redacted]. Subsequently, on [redacted], the DOG issued a notice decertifying the Unit as a tertiary recovery project under I.R.C. § 4993.

DISCUSSION

For WPT purposes, "incremental tertiary oil" is classified as tier 3 oil and thus is subject to the lower WPT rate of 30 percent. I.R.C. §§ 4987(b)(3), 4991(e)(1)(C). Under I.R.C. § 4993(a), "incremental tertiary oil" is defined as the excess of the crude oil which is removed from a property during any month and which is produced on or after the project beginning date and during the period for which a qualified tertiary recovery project is in effect on the property, over the base level for that property.

Under I.R.C. § 4993(c)(2), a project qualifies as a "qualified tertiary recovery project" if it satisfies four requirements: (1) It must involve the application of one or more tertiary recovery methods which can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which is ultimately recovered; (2) the date on which the injection of gas begins is after May 1979; (3) the portion of the property to be affected by the project is adequately delineated; and (4) the operator submits, as the Secretary prescribes by regulation, either a certification from a petroleum engineer that the project satisfies requirements (1) through (3), or a certification that a jurisdictional agency has approved the project as meeting requirements (1) through (3) and that such approval is still in effect. In addition, the operator must submit, as the Secretary prescribes, a certification from a petroleum engineer that the project continues to meet requirements (1) through (3).

There is no dispute in this case that the alkaline flood certified for the Unit by the DOG satisfied the above requirements. The only issue is whether the project beginning date under I.R.C. § 4993(d)(2) is the date when the preflush was commenced.

The "project beginning date" is defined in I.R.C. § 4993(d)(2) as the later of the date that injection of liquids, gases or other matter begins, or the date that a petroleum engineer or a jurisdictional agency certifies that

the project satisfies the requirements of subparagraphs (A), (B), and (C) of subsection (c)(2).

Under Prop. Reg. § 51.4993-1(d)(3), any liquid, gas, or other matter that is injected into a reservoir can be a tertiary injectant for purposes of determining the project starting date if certain conditions are met. First, it must be injected prior to injection of a primary injectant to preflush or treat the reservoir or to enhance the oil recovery of the primary injectant. Second, the amount of crude oil which could be recovered by use of that liquid, gas, or other material is significantly greater than the amount which can reasonable be expected to be recovered without its use, and the injection of that liquid, gas, or other material is followed within 180 days (or more, if a longer period is approved in writing by the Associate Chief Counsel (Technical) as necessary or appropriate under all of the facts and circumstances) by the injection of the primary injectant. 2/

The taxpayer contends that the project beginning date is [redacted], the date when the softened water preflush began. As implicitly acknowledged in your memorandum, the softened water used as a preflush would probably qualify as a tertiary injectant in this case because it was essential for pressuring the reservoir before use of the primary injectant. The operator arguably failed to qualify it as a tertiary injectant, however, because the preflush continued for more than 180 days without the requisite approval of the Associate Chief Counsel (Technical).

Although that regulatory requirement was not met, we do not believe the duration of the preflush without formal approval is the critical consideration. 3/ As noted in your memorandum, in a Technical Advice Memorandum issued for [redacted] (January 10, 1989), the Service concluded in the case of the [redacted] (located in New Mexico)

2/ For purposes of this provision, a "primary injectant" is any of the injectants described in paragraph (c)(1) through (9) of the June 1979 energy regulations. The alkaline injectant proposed in this case is one of the primary injectants described in the energy regulations.

3/ We also recognize that the Prop. Reg. § 51.4993-1 was not issued until September 10, 1984, when the preflush was already in its third year, and was never promulgated as a final regulation. For this reason, we believe the Tax Court would be reluctant to enforce this requirement, which is not contained in the temporary regulation (Temp. Reg. § 150.4993-1).

that the project beginning date for a miscible carbon dioxide project was the date on which the taxpayer began a multiyear overinjection of water to increase reservoir pressure for the project even though no formal approval was obtained for continuing the water injection for more than 180 days. The facts of the TAM differ from those in this case, however, because injection of the primary injectant ultimately occurred in the [redacted] project. In contrast, in this case the operator terminated the project before any primary injectant was ever used. We believe that this is a critical distinction.

The definition of incremental tertiary oil is clearly limited to oil produced from a qualified tertiary recovery project, which must involve one of nine specified tertiary recovery methods or a method approved by the Secretary. I.R.C. § 4993(a)(1), (c), (d)(1). Moreover, the provision in Prop. Reg. § 51.4993-1(d)(3) that would recognize a nonprimary injectant as a tertiary injectant is conditioned on the use of the nonprimary injectant for a limited period of time and upon the eventual use of a primary injectant. In addition, I.R.C. § 4993(c)(2)(E) requires the operator to submit a certification from a petroleum engineer that the project continues to meet the requirements of I.R.C. § 4993(c)(2)(A)-(C), as prescribed by regulations. 4/

In this case, no primary injectant was ever used, while the softened water preflush continued for nearly five years. Because the project was decertified before any primary injectant was ever used, we believe that the decertification should be treated as retroactive for WPT purposes. In effect, absent the use of the primary injectant, it is as if there had never been any certification.

Although the operator modified the waterflood program and began the softened water injection in [redacted] neither of these activities necessarily indicates the intent to undertake a tertiary program. As noted in the report of Petroleum Engineer Joseph W. Yager, the changes in [redacted] are consistent with simply improving the efficiency of the existing waterflood project and were economically justified even without the prospect of a tertiary recovery program. It is clear from the legislative history that a waterflood operation does not qualify as a tertiary recovery method for purposes of this provision. See H. R. Rep. No. 817, 96th Cong., 2d Sess. 98 (1980), 1980-3 C.B. 245, 258. Thus, under these

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4/ Prop. Reg. § 51.4993(d)(6) would require the operator to submit the petroleum engineer's certification every six months for the duration of the project.

circumstances we conclude that there was no qualified tertiary recovery project within the meaning of I.R.C. § 4993(c) and, hence, no project beginning date.

We recognize that the legislative history indicates that the revocation of a certification issued by a regulatory body is not necessarily retroactive. In particular, the Senate report contains the following discussion:

> Certification revocation. -- A certification issued by a regulatory body after a review of the producer's application would remain effective for tax purposes, unless (1) a material fact was misrepresented by the producer or its agent in obtaining the certification, or (2) the project was not implemented and operated in a manner reasonably consistent with the plan upon which the certification was based. If either of these facts is established, a revocation of the project's tax certification, and hence its exemption, may be retroactive. However, if a project was implemented and operated initially in a manner reasonably consistent with the plan upon which the certification was based, and subsequently was modified in a nonqualifying manner, a revocation would be effective only as to the date of the nonqualifying modification.

Sen Rep. No. 394, 96th Cong., 1st Sess. 48 (1979), 1980-3 C.B. 131, 166.

Notwithstanding the quoted passage, we believe that our conclusion is consistent with the overall legislative intent of the WPT provisions for incremental tertiary oil. We do not interpret the passage above to mean that a taxpayer could qualify under I.R.C. § 4993 merely by commencing a purported preflush and never actually beginning use of the primary injectant. Nor do we believe that Congress specifically considered whether the commencement of a preflush phase would mark the project beginning date. 5/

In discussing the project beginning date, for example, the Senate report states that "the project will not be considered to have commenced if the tertiary injectant is

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5/ By treating a nonprimary injectant as a tertiary injectant under certain conditions, the proposed regulation would provide a more flexible definition of the project beginning date than required by a strict reading of the Code and the legislative history.

utilized merely on a pilot or experimental basis." Id. at 45, 1980-3 C.B. at 163. In addition, the report goes on to state that "[s]imilarly, mere preparation or planning for the tertiary process, such as drilling an injection well, would not be sufficient to establish the project's beginning date." Id. These passages indicate that Congress contemplated that there must be an unequivocal indication that the tertiary project would actually go forward before any oil could qualify for the WPT tier 3 rate. Because the extended preflush in this case could be viewed as merely an improvement to the existing waterflood program, we believe that the failure to use any primary injectant is a fatal defect.

Although we have concluded that none of the oil produced from the Unit during the tax years at issue was incremental tertiary oil, we are concerned about litigating this issue against the petitioner in this particular case. We understand that the petitioner here is an elderly woman who owns a royalty interest in the Unit. Although she falls within the definition of a "producer" under I.R.C. § 4996(a)(1) because her royalty is an economic interest, she does not own a working interest in the Unit and clearly had no control or voice in the operation of the Unit. Although these considerations are theoretically not relevant to the legal issue in the case, we believe that they pose a potential litigation hazard.

In our estimation, this may be a difficult issue to litigate, and we do not consider this case to be the most promising vehicle for obtaining a favorable result. Accordingly, we strongly recommend that efforts be taken to resolve this case through settlement.

In recommending settlement of this case, we do not mean to discourage litigation of the issue. On the contrary, we believe that the issue should be pursued and suggest that an appropriate vehicle would be a case involving the operator of the Unit.

Please contact the undersigned at FTS 566-3308 or Gerald Fleming at FTS 566-3345 if you have any questions.

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